DEC 14 1988

Beth L Williams, Special Trial Attorney

Phyllis E. Marcus, Chief CC:INTL:Br2

[redacted]
INTL-0498-88

This is in response to your memorandum, dated July 27, 1988, with respect to [redacted]. In that memorandum, you requested our advice on the interaction between subpart F of the Code and the foreign personal holding company provisions of sections 551 through 558. You also requested our advice on whether the issues presented by this case should be settled or litigated. The specific issues for our consideration are:

(1) Whether [redacted] must include in its gross income under section 551(b) an amount equal to the undistributed foreign personal holding company income ("UFPHC income") of its wholly-owned subsidiary, [redacted], if [redacted] had previously taxed earnings and profits that exceed the amount of its UFPHC income?

(2) Whether [redacted] must include the foreign personal holding company income of [redacted] in gross income under section 951(a)(1)(A)(i) if [redacted] is subject to section 551(b) but did not actually pay taxes under section 551(b) because of [redacted]'s previously taxed earnings and profits.

Facts:

[redacted] ("[redacted]") is a domestic corporation which was, for the years at issue, owned by five or fewer U.S. individual shareholders. [redacted] owns all the stock of [redacted] ("[redacted]"), a Swiss corporation, which in turn owns all of the stock of [redacted].

[redacted] has been both an operating company and the recipient of passive royalty and interest income. Prior to its fiscal year ended [redacted] part or all of [redacted]'s income constituted subpart F income and was included in the income of [redacted] under section 951(a)(1)(A). In addition, a portion of [redacted]'s income was included

[redacted]

in the gross income of [redacted] under section 951(a)(1)(B) as a result of [redacted]'s increase in earnings invested in United States property. As of [redacted], [redacted] had previously taxed earnings and profits as defined in section 959(a) of $[redacted] some of which represented previously taxed earnings of [redacted] which had been distributed to [redacted].

In the fiscal year ended [redacted], [redacted]'s foreign personal holding company income ("FPHC income"), as defined in section 553, exceeded [redacted] percent of its gross income for the first time. Its FPHC income also exceeded [redacted]% of gross income for the fiscal years ended [redacted] through [redacted]. Because [redacted] was indirectly owned during the years at issue by [redacted] or fewer U.S. individual shareholders under the constructive ownership rules of section 554(a), it was a foreign personal holding company for the fiscal years ended [redacted] through [redacted].

For the taxable years from [redacted] to [redacted], [redacted] had FPHC income in the following amounts:

Year	FPHC income
[redacted]	$[redacted]
	$
	$
	$

In each of the fiscal years listed above, [redacted] had current earnings and profits equal in amount to its FPHC income.

[redacted] also made distributions in the fiscal years ended [redacted] through [redacted] as follows:

Year	Distribution
[redacted]	$[redacted]
	$
	$

Law and analysis:

Section 551(b) states, in relevant part, that "each United States shareholder who was a shareholder on the day in the taxable year of the company which was the last day on

[redacted]

which a United States group (as defined in section 552(a)(2)) existed with respect to the company, shall include in his gross income, as a dividend, for the taxable year in which or with which the taxable year of the company ends, the amount he would have received as a dividend... if on such last day there had been distributed by the company, and received by the shareholders, an amount which bears the same ratio to the undistributed foreign personal holding company income of the company for the taxable year as the portion of such taxable year up to and including such last day bears to the entire taxable year." (Emphasis added). The undistributed foreign personal holding company income means the taxable income of a foreign personal holding company adjusted in the manner provided by section 556(b), minus the dividends paid deduction, as defined in section 561. Section 556(a).

[redacted] contends that a distribution of the UFPHC income of [redacted] would not have been received as a dividend by [redacted] because of the operation of section 959. Section 959(a) provides that for purposes of chapter 1 of subtitle A of the Code, "the earnings and profits for a taxable year of a foreign corporation attributable to amounts which are, or have been, included in the gross income of a United States shareholder under section 951(a) shall not when such amounts are distributed to such shareholder be again included in the gross income of such shareholder. Section 959(c) provides, generally, that distributions are considered to be first from previously taxed earnings and profits and then from other earnings and profits. Section 959(d), provides, generally, that a distribution which is excluded from the gross income of a U.S. shareholder because it is treated as a distribution of previously taxed earnings and profits is treated as a distribution which is not a dividend. Based on these provisions of section 959, [redacted] asserts that if an amount equal to the UFPHC income of [redacted] had been distributed, it would not have been received as a dividend because the previously taxed earnings and profits of [redacted] exceeded the UFPHC income during the years at issue.

In your memorandum to the Examination Division, you concluded that [redacted] must include the UFPHC income in gross income for the taxable years at issue because (1) section 951(d), as it read prior to its amendment by the Tax Reform Act of 1984, gives the foreign personal holding company provisions precedence over the provisions of subpart F, and (2) section 959 permits the exclusion of only those earnings

[redacted]

and profits attributable to amounts which are or have been included in gross income of a United States shareholder under section 951(a). We agree with your conclusions.

Prior to its amendment in the Tax Reform Act of 1984, section 951(d) stated that "a United States shareholder who, for his taxable year, is subject to tax under section 551(b) (relating to foreign personal holding company income included in gross income of United States shareholders) on income of a controlled foreign corporation shall not be required to include in gross income, for such taxable year, any amount under subsection (a) with respect to such company." Thus, for taxable years beginning before July 19, 1984 (the effective date of the Tax Reform Act of 1984) if the foreign personal holding company rules and the subpart F rules overlapped, the foreign personal holding company rules take precedence. Consequently, the foreign personal holding company provisions must be read independently of subpart F. This result is confirmed by the regulations under §1.556-1 which state that the UFPHC income is the taxable income of the foreign personal holding company as defined in section 63(a), computed without regard to subchapter N, chapter 1 of the Code. Section 959 is contained in chapter 1 of subchapter N. Although §1.556-1 was written prior to the adoption of subpart F, it was not altered after the enactment of subpart F, although other portions of the foreign personal holding company regulations were changed. <u>See e.g.</u> §1.562-1(a). Thus, the foreign personal holding company rules are to be applied to current earnings and profits without regard to subpart F, and [redacted] may not apply section 959 to compute the amount that would have been received as a dividend had [redacted] distributed its UFPHC income.

In addition to the above, [redacted] relies on a mistaken reading of section 959. Section 959(a) states, in relevant part, that "the earnings and profits for a taxable year of a foreign corporation attributable to <u>amounts which are, or have been, included in the gross income of a United States shareholder under section 951(a)</u> shall not, when -- (1) such amounts are distributed to...such shareholder...be again included in gross income of such United States shareholder...." (Emphasis added). Moreover, the regulations under sections 1.959-1(a) and (b) make clear that section 959 applies only to actual distributions. Thus, section 959 only prevents earnings and profits that have already been included in the gross income of a United

[redacted]

States shareholder under section 951(a) from again being included in gross income when such earnings and profits are actually distributed. [redacted]'s attempt to apply section 959 to amounts of current earnings and profits which have not been included in gross income under section 951(a) and which have not been distributed is, therefore, erroneous.

Based on the foregoing, we conclude that [redacted] must include in its gross income, as a dividend, the UFPHC income of [redacted] for the taxable years in question. We also recommend that the Service litigate the case if necessary.

Because we have found that [redacted] is taxable on its FPHC income under the foreign personal holding company provisions, it is unnecessary to address the issue of whether [redacted] must include the FPHC income of [redacted] in gross income under subpart F. That income is excluded from subpart F under section 951(d).

With respect to actual distributions in a year that [redacted] has UFPHC income, section 959(c) is applied before section 561. Thus, current year distributions made by [redacted] with respect to its stock come first from previously taxed earnings and profits. Section 959(c) and §1.959-3. If the distribution exceeds [redacted]'s previously taxed earnings and profits, the distribution shall come from other earnings and profits, if any, and may qualify for the dividends paid deduction under section 561. Any undistributed earnings and profits attributable to UFPHC income which are included in gross income under section 551(b) will, with respect to subsequent year distributions, reduce [redacted]'s earnings and profits at the end of the year of the inclusion.